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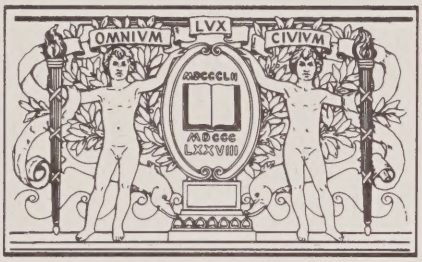

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WHAT DRIVES THE BOSTON REAL ESTATE MARKET?

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WHAT DRIVES THE BOSTON REAL ESTATE MARKET?

Summary

For the better part of a decade now commercial and residential investment demand and property values have been rising spectacularly. 1984 set new records in commercial investment and property value growth as a consequence of double the rate of employment growth (20,000) and development investment completions ($2.3 billion), and double the square footage of new office space coming on to the market (2.8 million square feet) and the rate of space absorption (2+ million square feet), in that year, all in comparison with the 1976-84 period of revival of the Boston economy. The rate of housing value growth, in 1984 (20 percent), was also double that of the 1975-84 period. 1985 value growth will continue to march ahead as the supply of new space this year will slacken; for office space there will be less than half the annual average addition to supply; in the case of hotel rooms, only a third of the annual average since 1980; and in housing, the severe shortage will exacerbate as the growth in households confronts a very limited increment in supply. And for the decade ahead, looking to 1990 and 1995, an extraordinary construct of factors, local, state and national, will generate very strong investment demand and property value growth.

Many, but not all of the factors impelling property value growth, recent and prospective, in Boston, are embodied in the considerations that may be adduced in the recent Equitable Life purchase of the Bank of Boston headquarters building (1.2 million square feet of net usable space) for $363 million, in relation to the reported building cost of $80 million, in 1971, as follows:

(1) Equitable has a strong assessment of the current office market in Boston. Using a rough rule of thumb of monthly office space rentals as equal to 1 percent of market value, the Bank of Boston building had a Class A market rental cost of $8 a square foot, in 1971, and now has a market rental cost of $36 a square foot (in comparison with the current average of $30 a square foot for Class A space in Boston).

(2) Equitable must be counting on a doubling, at least, of the value of its newly acquired property (and related office rental to the Bank of Boston) over the next ten years. The 3+ percent per year increase in commercial property taxes permitted under Proposition 2½, and the 4 to 5 percent stable inflation rate that could be conservatively assumed, put a growth rate floor of 7 percent per year on value and rentals, signifying a doubling every ten years.

(3) Equitable is assuming demand for office space in Boston will experience strong growth (to sustain value), with a replication of the outstanding recent performance of the City of Boston and metro area economies, and their services and high tech industry base, which are well in tune with the sectors of the national economy expected to expand most rapidly, and with very favorable growth prospects projected to 1990 and 1995.

(4) Equitable must have in mind that Boston, with its limited supply of office space and housing, and limited land available for development, in the face of a growing preference for Downtown business and residential location (as evidenced by the post-1978 rate of rise in housing prices and office rentals), will continue to experience the most rapid increase in property value growth relative to that of the other metro area cities and towns.

(5) Equitable knows that new 1 million square feet office buildings in Downtown Boston, in the 1985-95 decade, will be few and far between, even with the projected construction of 12+ million square feet of space in the ten years ahead.

(6) Equitable undoubtedly noted that Boston's planning and development process is constraining office development to the pace of the growth of demand to assure an orderly office market, as part of sound development policy and tax base management. This was reiterated in the recent report on Downtown Projects; Opportunities for Boston, issued last October. This official policy lends confidence to the real estate industry that the Houston, Dallas and Denver experience is not likely to be repeated in Boston.

(7) Equitable's purchase reflects the "profitability" past and prospective of office development in Boston. In the case of the Bank of Boston headquarters building, the historic record suggests a hypothetical long-term rate of return, 1972-84, of

19 percent (annual average) made up of the 7 percent per year appreciation in value and the 12 percent (floor) return as owner-renter. (By way of a caveat, it should be noted that the implied total development cost of $302 per square foot, in 1984, surpasses that of today's most costly development in Boston--International Place, at $250 a square foot--suggesting tax considerations in the Bank of Boston building price--opting for capital gains as a trade-off on rental income agreement.)

(8) Equitable's calculations, in part, must include the effect of Proposition 2½ on the reduction of the property tax burden for commercial property. One view of this may be seen in the changing rule of thumb on the commercial property tax levy as a percent of gross rental income. Prior to 2½, commercial property taxes were frequently calculated at 30 percent of rental income. For 121A properties, this percentage dropped to 20 percent. Currently, post-2½, the effective commercial property tax rate is equivalent to 15 percent of rental income, and this percentage will fall in the future as the commercial property share of total taxable property rises.

In summary, structural transformation of the Boston economy--recent, current, and prospective--and a commercial and residential investment demand stronger than the supply response, taken together make up the principal engine driving property values, <u>but far from the only one</u>.

Lower tax burdens, city, state and federal, are also boosting property values and freeing up savings available for property investment. Lower property tax levies, mandated by Proposition 2½, translate directly into higher property values. A notable reduction in the overall Massachusetts tax burden, in comparison with other states, has also been important. And since 1983, the curtailment of federal corporate and personal income taxes have reduced these levies for the first time in recent history. A rising flow of savings has been available to respond to the strong investment demand in Boston, adding another layer of growth to property values.

The performance of the national economy, with a stable rate of inflation and lower interest rates contributing to the growth in investment demand and the rise in property values has been a third major element. An analysis by the Federal Reserve Bank of Boston characterizes the current (cyclical) expansion as the largest and strongest since the Korean War, and one which centers principally in business investment growth in response to the "huge increase in economic profits" and the stimulative role of federal fiscal policy (the rise in expenditures in relation to revenue), especially since 1983. Abundant harvests, slack energy markets world-wide, and modest wage settlements, are credited with the recent and prospective attenuation of inflation and interest rates.

In addition, another "Boston factor" holds the prospect for significant contribution to the growth in investment and property values over the next decade. Three key transportation infrastructure facilities underway, scheduled and planned, respectively, will open up for development close-in areas of the City which are presently grossly underutilized. The relocated Orange Line, nearing completion in the Southwest Corridor, will be a major factor in the redevelopment of Roxbury, where land costs are low and much of it publicly owned or controlled. The depression and rebuilding of the northern branch of the central artery (fully funded and in the engineering drawing stage) will improve access and redevelopment of the Charlestown Navy Yard. The Northern Avenue Bridge, fully funded and with an agreed-on engineering design, will make generally accessible the Fort Point Channel Area with its vacant and underutilized land parcels. Accessibility for development projects waiting in the wings will enhance property values

in these areas over the next decade. Rise in values will also be advanced by likely constraints on Downtown development as a consequence of urban design, amenity and environmental considerations.

Taken together, the factors of (1) recent and prospective growth in the Boston economy and related investment demand, (2) lower property taxes and state and federal tax burdens, (3) stimulative national fiscal policy, rising "economic profits: and business investment, and (4) emerging transportation infrastructure improvements in Boston and access to close-in underutilized land, can be counted on to drive the Boston real estate market for the next decade.

A thriving real estate market signifies opportunity. On the way to making most of the opportunity, the real estate industry could advance the prospects for success by taking the leadership in the struggle for an improved revenue base for the City of Boston.

I. The Boston Real Estate Market

Residential and commercial property values have been rising boldly for the better part of the last ten years, and 1984 established some important new marks. For the decade ahead, the outlook is for continued strong gains in value, with the supply of commercial and residential development underway, scheduled and planned for the next five years hard put to match emerging demand, while development projects just reaching the drawing board, for implementation in the 1990-95 years, barely match projected growth in demand.

The increase in office rents and hotel room rates demonstrates the unprecedented rise in commercial property value. Class A office space rentals in the City have risen from $10 a square foot, in 1977, to $30,

in 1984. Prime tower space in new structures just coming on to the market is renting at up to $60 a square foot. And a banner year of new office space completions (2.8 million square feet--more than twice the average of the previous ten years) was matched by an estimated absorption of 3 million square feet (also more than twice the annual average of the last decade), more than sustaining the pressure on rentals and values.

In the case of hotels, room rates have soared from an average of $40, in 1979, to $80, in 1984. And the completion of 2,000 new hotel rooms, in 1984, adding 20 percent to the stock, was accompanied by very respectable occupancy rates (68 percent), as Boston enjoyed a good hotel and convention year.

Boston is experiencing a severe housing shortage, and a decade of value growth was capped by record increases in 1984. The average value of a single family home, in Boston, has increased from $25,000, in 1975, to $63,000, in 1984. A major local bank research office tracking institutional lenders reports that average mortgage loans (usually 80 percent of value) rose from $45,000, in 1980, to $55,000, in 1983, and $65,000, in 1984. The National Association of Realtors reported, in November, that the Boston metro area had the largest increase (19 percent) in the median price for resale homes of any of the 37 major metro areas surveyed. The median resale price, $102,000, was exceeded by only 6 of the 37 metro areas. In December, the Greater Boston Real Estate Board reported home prices were at least 20 to 25 percent higher than in 1983.

Boston's Assessing Department reported (in November) value growth, in 1984, of 11 to 20 percent for one-, two-, and three-family housing,

15 percent for condominiums and industrial property, and 24 percent for commercial property.

As noted, the rise in value, in 1984, responds to record growth in the Boston economy, reduction of tax burdens, and the performance of the national economy and federal fiscal policy. Prospective economic growth and development demand, combined with the opening up of close-in areas through the completion of three key transportation infrastructure facilities, will assure continued property value growth over the next decade.

II. The Boston Economy

The structural transformation of the Boston economy has been accompanied by employment growth (including a record 20,000 job gain in 1984), the post-1980 reversal of population decline, and a private development investment boom (including $2.3 billion of completions in 1984), all impacting the Boston real estate market. Prospects for the 1985-90 period are outstanding with the recently announced approval of ten major development projects signifying 25,000 new permanent jobs and 5 million square feet of office space. And a next generation of development projects, waiting in the wings, and responding to favorable projections of the growth of the Boston economy, will assure a very active development agenda for 1990 to 1995, further strengthening property values.

Employment

Boston's gain of 80,000 jobs in the 1976-84 years including a record increase of 20,000 in 1984, twice the average for the period,

reflects the fundamental impact of the transformation of the economic base, with a relative concentration in the broad range of communications, money management, professional and business services activities expanding most rapidly nationally. Important, also, is the superior performance of the metro region economy (in comparison with other major metro areas and the nation as a whole), and its high-tech industry, which draws heavily on the services of the Boston economy. Retail trade employment growth in 1984 (including eating and drinking establishments) was one of the more rapidly growing activities, with new facilities and higher sales as newly completed development investment reinforced the role of Boston as the most important retail center in New England. Office employment rose by more than 12,000 in 1984, more than twice the average annual growth rate since 1976.

Metro Area Growth

Boston's metro area is outperforming the nation, the region, and other large industrial centers in employment growth, and with an unemployment rate so low as to signify a labor shortage. As of October 1984, the latest date for which information is available, metro area unemployment was at the more-than-full-employment rate of 3.1 percent in comparison with 4.1 percent for the City of Boston and 7.4 percent for the nation as a whole.

Reversal of Thirty Years of Population Decline

Young adult, middle-class, professional households are flowing into Boston, and the limited supply of housing is hard put to meet their demand. The Census Bureau reported an estimated 1980-82 population

increase of 6,000 for Boston--the first rise in thirty years. The gain came as a consequence of the attraction of the City's jobs and amenities and the growth in one-person and two-person households, the most rapidly growing population group nationally (and a group which prefers city living). These households make up 66 percent of all households in Boston, in comparison with 46 percent for the nation as a whole, and their smaller size, relative to population numbers, means more housing needed.

In the 1970-80 decade, Boston's 25- to 34-year old population, with a concentration of one- and two-person households, had grown by 28,000. Boston's households had increased by 4 percent in the 1970-80 decade even though population had declined by 12 percent. For centrally located neighborhoods, the growth in households had been 7 percent.

Boston is in the throes of an acute housing shortage. In relation to the 1970-80 decade's construction of 28,000 dwellings, principally publicly-assisted, only 4,478 new dwellings and 3,236 dwellings converted from other uses have been completed or are underway thus far in this decade. This has been insufficient to accommodate demand arising from the growth in jobs and households and the need for replacement and upgrading.

With a projected population growth of 45,000, in the 1985-95 decade, there will be a substantial need for new housing, at all income levels. Opportunities for home ownership will be encouraged for low- and moderate-income households. For housing for middle- and upper-income households, investors may be expected to rediscover the advantages of rental housing, and increments in value accruing to investor owners.

Investment Boom

The City's $2.3 billion of private development investment completions in 1984 was a record level (in relation to the $11.4 billion completed since 1975 as well as that currently underway, scheduled and planned--all measured at total development cost, in dollars of constant value at 1983 prices) and responded to the growth in employment, population, and households. The private-public investment ratio was a healthy 3:1, in stark contrast to that six years earlier, in 1978, which was 0.8:1 following the impact of the mid-70s' recession and the record level of office building completions in the preceding years.

A near record level of completion of 2.8 million square feet of office space in 1984 was matched by the absorption of a record 3 million square feet of space.

In 1985, in contrast, only 600,000 square feet of new space is scheduled for completion, to meet the burgeoning demand, and an office space shortage may emerge by year-end.

Outstanding Outlook to 1990

The recently announced recommendations for the approval of ten major downtown projects designed to accommodate 25,000 new permanent jobs, and provide very substantial revenue and benefits to the City, will add 5 million square feet of office space, signifying a 20 percent increment to Boston's office stock and representing the second largest addition to Boston's economic base in the City's history.

The scheduled private investment projects go a long way to realizing the employment gains projected for Boston to 1990. Projections of Boston employment, in relation to those for the nation as

a whole, suggest a 1983-1990 growth of 30,000 office jobs, an employment gain of 44,000 for Central Boston (the area encompassed by Massachusetts Avenue) and 72,000 net new jobs for Boston as a whole.

A Next Generation of Development, 1990-95

A next generation of development to 1995, includes plans and projects just beginning to reach the drawing board. This next stage of development will generate an additional 50,000 jobs, according to our longer-range projections for the Boston economy. This will include 21,000 office jobs, and an employment growth of 31,000 in Central Boston.

There are imaginative development projects in the wings for Boston's Harborpark neighborhoods and inner city neighborhoods including Dudley Square, as well as downtown. This time development will be the handmaiden of planning and citizen participation.

The next generation of development will be designed to go beyond the strengthening Boston's new economic structure in services, money management, and the knowledge industries. There will be new thrusts in the development of back office space, high-tech industry, incubator space, and housing, including housing for low- and moderate-income families.

The next phase of development will accommodate Boston's population revival, a larger growth in the number of households, and robust residential development.

III. Lower Tax Burdens

Tax burdens have declined notably at all levels--local, state and federal, and are an important factor in property value growth. In the case of property taxes, the reduction in levy impacts value directly. Lower state and federal tax burdens are freeing up savings which have been flowing into investment and boosting property values.

Boston's property tax levy of $519 million, for FY1981, fell to $333 million, in FY1984, as Boston complied with Proposition 2½. Though levies are now rising, the $30 million levy increment for FY1985 reflects new construction principally ($22 million), and value growth secondarily ($8 million).

The Massachusetts state and local tax burden, relative to personal income, was 8.4 percent below the average for all states, in 1984, in accordance with a report of the state Commissioner of Revenue. This represented a notable change from the recent past. In 1979, the Massachusetts tax burden (relative to personal income) had been 11.3 percent above the average for all states. It has been declining ever since, passing below the states' average, in 1982. Commissioner Jackson projects an even lower burden by 1990. Three principal factors account for the lightening of the relative tax burden in Massachusetts, (1) a more rapid expansion of the state economy and growth in personal income (the denominator in the measure of tax burden), in comparison with other states, (2) flat rate state income and corporate taxes which do not rise progressively with income (as in many other states), and (3) the Proposition 2½ mandated reduction in city and town tax levies throughout the state. In addition, approximately two-thirds of the states have increased state taxes (since 1979) and Massachusetts hasn't.

Reduction in the federal corporate and personal income tax levies in FY1983 totalled $10 billion. The curtailment of federal corporate income taxes, which began earlier, reduced their share of total federal tax revenue from 16 percent, in FY1979, to 9 percent, in FY1983.

IV. Performance of the National Economy

The recent strong performance of the national economy, responding to business investment growth and expansionary federal fiscal policy, at a time of a stable, modest rate of inflation, is an important factor generating savings and investment and bolstering the growth in property values.

In an article entitled "The Current Expansion in Historical Perspective," in the New England Economic Review, November/December, 1984, published by the Federal Reserve Bank of Boston, Stephen K. McNees, finds that the current economic (cyclical) expansion, since the end of the 1982 recession, has been much stronger than average, and, in fact, the strongest since the Korean War boom. McNees identifies business investment as the lead sector in the expansion, with the growth of capital spending surpassing the previous strongest advance (in the cyclical increase of 1954-55). He notes that "besides the strength of the expansion, another factor behind this extraordinary growth in capital spending is the huge increase in economic profits," flowing, in part from liberalized depreciation rules.

McNees goes on to note that "one explanation for the strength of this expansion is the stimulative role of fiscal policy" with expenditures exceeding revenues.

Finally, McNees reports that "through the second year of this expansion, the rate of price inflation has held steady". This is attributed to stability in labor compensation growth, bountiful harvests, and the weakness of energy prices worldwide.

These factors, (1) tax policy generated rising "economic profits" and expanding business investment, (2) stimulative fiscal policy, and (3) stable inflation rates attenuated by modest wage gains and adequate food and energy supplies, could be with us for some time in the foreseeable future, providing important underlying strength for property value growth.

V. Three Key Transportation Infrastructure Links Currently Underway, Scheduled and Planned

Three key transportation infrastructure links, all fully funded, will remake the development geography of Boston by opening up close-in areas of the city, providing access, and facilitating important development projects and prospects, which will contribute significantly to property value growth in Boston. The relocated Orange Line in the Southwest Corridor, the Northern Avenue Bridge to the Fort Point Channel Area, and the depression of the northern branch of the Central Artery are, respectively, nearing completion, ready to go with an agreed upon design, and in the engineering drawing stage. These key transportation links, which will come on line in the next several years will substantially advance the encompassing of Roxbury into the mainstream of the City's thriving economy, will unleash long-planned development in the Fort Point Channel area, and will advance the redevelopment of the Charlestown Navy Yard. Development of underutilized close-in areas of the City will bring very substantial growth to property values.

Currently, much of the land in these close-in areas is vacant and underutilized, and much is publicly owned or controlled.

In effect, these three transportation infrastructure projects will open up a new horizon for planning and development, and property value growth in "our time".